APPENDIX A

Review of CMS's preliminary estimate of the physician update for 2005

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Medicare's payments for physician services are made according to a fee schedule that assigns relative weights to services, reflecting resource requirements. These weights are adjusted for geographic differences in practice costs and multiplied by a dollar amount—the conversion factor—to determine payments. Thus, the conversion factor is a key element of the payment system. If it changes, there is a proportional change in the payment rates for all of the more than 7,000 services represented in the fee schedule.

The conversion factor is updated annually, based on a formula in law that is designed to control spending while accounting for factors that affect the cost of physician services. The Centers for Medicare & Medicaid Services (CMS) issues a final rule on the update in November of each year and implements the update on January 1 of the following year. To help the Congress and others anticipate the update, the Balanced Budget Refinement Act of 1999 (BBRA) requires CMS to prepare, by March 1 of each year, a preliminary estimate of the next year's update. The BBRA also requires MedPAC to review that estimate in the Commission's June report. This appendix fulfills the requirement that we review the estimate of the update for 2005.

In passing the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), the Congress amended the update formula for physician services and required an update for 2005 of no less than 1.5 percent. CMS has estimated the update for 2005—based on the formula but without the MMA minimum—at –3.6 percent. Thus, because of the statutory requirement for a minimum update, CMS concludes that an update of 1.5 percent is likely. MedPAC agrees that a 1.5 percent update is the most likely scenario. It is unlikely that the figure will be higher than 1.5 percent, because such an increase would require a large decrease in the volume of physician services, which is very unlikely based on historical trends.

In reviewing CMS's estimate, our purpose is not to assess the adequacy of the update.[1] Instead, the review that follows is limited to the technical issues involved in CMS's estimated update based on the statutory formula.

Calculating the update

Calculating the update is a two-step process. First, CMS estimates the sustainable growth rate (SGR). The SGR is the target rate of growth in spending for physician services and is a function of projected changes in:

- input prices for physician services,[2]
- real gross domestic product (GDP) per capita,[3]
- enrollment in traditional fee-for-service Medicare, and
- spending attributable to changes in law and regulation.

For 2005, CMS's preliminary estimate of the SGR is 4.6 percent (Table A-1).

TABLE A-1 **Preliminary sustainable growth rate, 2005**

Factor	Percent
Change in input prices	2.6%
Change in traditional Medicare enrollment	–0.2
Change in real GDP per capita	2.2
Change due to law and regulations	0.0
Sustainable growth rate	4.6

Note: GDP (gross domestic product).

Source: Gustafson 2004.

Second, CMS calculates the update, which is a function of:

- the change in input prices for physician services,[4]
- a legislative adjustment required by the BBRA,[5] and
- an update adjustment factor that increases or decreases the update as needed to align actual spending, cumulated over time, with target spending determined by the SGR.

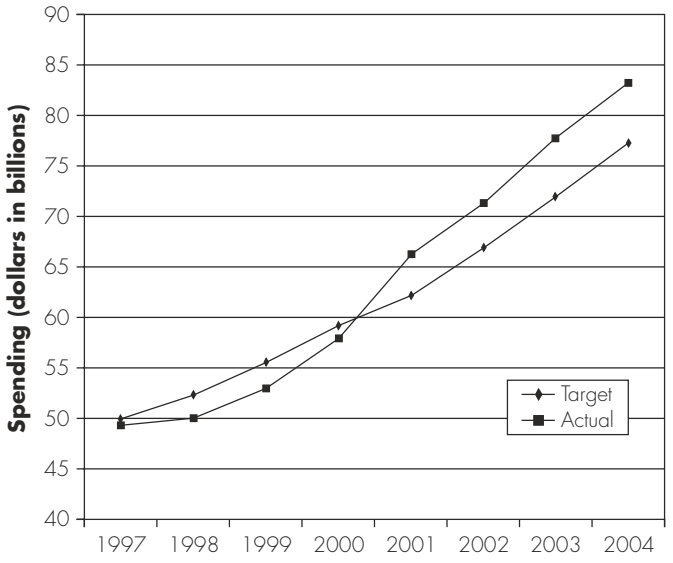
Of these factors, the update adjustment factor has the largest effect on the update estimate for 2005 (Table A-2). For 2005, the figure is –7.0 percent, which is the maximum negative adjustment permitted under current law.[6] The factor is negative because actual spending for physician services started to exceed the target in 2000 and is projected to stay above the target at least through 2004 (Figure A-1). When this adjustment is combined with the other factors that determine the update for 2005—a change in input prices of 2.8 percent and a legislative adjustment of 0.8 percent—the result is an update of –3.6 percent.

TABLE A-2 **Estimate of the update for physician services, 2005**

Factor	Percent
Change in input prices	2.8%
Update adjustment factor	–7.0
Legislative adjustment	0.8
Update	–3.6

Source: Gustafson 2004.

FIGURE A-1 **Estimated actual spending for physician services to exceed target through 2004**



Source: Office of the Actuary 2004 and Gustafson 2004.

Reviewing CMS's estimate

For the 2005 SGR, MedPAC anticipates no changes in CMS's estimates that will be sufficient to alter the update. The estimate of the change in input prices, as measured by the Medicare Economic Index (MEI), is similar to changes in the MEI for earlier years.[7] The change in real GDP per capita of 2.2 percent equals the 10-year moving average of real GDP estimates from the Bureau of Economic Analysis, adjusted for population growth (BEA 2004).

On issues related to the other two factors in the SGR—enrollment and spending due to changes in law and regulation—CMS's estimates may be somewhat less certain. CMS assumes a decrease in fee-for-service enrollment of 0.2 percent. This is different from the enrollment projection from the Congressional Budget Office (CBO), which is an increase in fee-for-service enrollment of 0.9 percent for 2005. A decrease could

occur, but only if there is a shift in enrollment from Medicare fee-for-service to Medicare Advantage.[8] CMS's ability to project the magnitude of any such shift should improve as we gain further experience with Medicare Advantage. This experience is critical because of the importance of enrollment growth in determining the SGR, and therefore, the target for spending over time.

As to changes in spending due to law and regulation, CMS estimates no changes for 2005 because of offsetting provisions in the MMA. Under the law, several new benefits will start in 2005: a preventive physical for new beneficiaries, cardiovascular screening blood tests, and diabetes screening tests. In addition, spending will increase because of incentive payments for physician services furnished in physician scarcity areas and health professional shortage areas. The total increase in spending—the incentive payments plus the new benefits—will equal $230 million, according to CMS's estimates.

By contrast, other requirements in the MMA will result in a decrease in payments—payments for administration of drugs covered by Medicare Part B—in 2005. The decrease will occur because of a drop in the size of a transitional adjustment in 2005, compared to 2004. The adjustment will drop from 32 percent to 3 percent, as a percentage of payments for drug administration under the physician fee schedule. CMS estimates that this decrease will equal $200 million and will almost fully offset the increases in spending due to the new benefits and the incentive payments.[9]

In reviewing CMS's estimate of the law and regulations factor for the SGR, we learned from CBO that they do not independently calculate this factor. However, CBO agrees that the cost-increasing and cost-decreasing provisions in the MMA approximately offset each other.

MedPAC cannot assess the magnitude of these estimates. Nevertheless, we judge that the estimates, and the difference between them, are not large enough to change the update for 2005.

The remaining issues concern CMS's estimates of actual spending. Data on actual spending are nearly complete through the first three quarters of 2003 but are less complete for the last quarter of that year. Therefore, the estimate of actual spending in 2003 may increase or decrease somewhat before CMS issues a final rule on the update in November 2004. The uncertainty regarding 2004 estimates is greater than for 2003 because CMS currently has no information on actual spending for that year. The agency has responded to this uncertainty by using stochastic projection techniques to analyze variation in the update adjustment factor (Office of the Actuary 2004). Under a range of possible scenarios for growth in real GDP per capita and growth in the volume of physician services, the analysis shows a 95 percent probability that the update adjustment factor will equal the maximum negative adjustment of –7.0 percent.

A maximum negative adjustment has such a high probability because a different outcome would require an uncharacteristic decrease in spending for physician services in 2004. An update of 1.5 percent for 2004 has already occurred. Without a sudden shift of enrollment from Medicare fee-for-service to Medicare Advantage, the only way for spending to fall is through a substantial decrease, at least 4 percent, in the volume of physician services per beneficiary. Such a decrease is very unlikely, however, based on historical trends. Since 1999, for example, volume has increased at an average annual rate of about 5 percent per year. For this reason, MedPAC agrees with CMS's conclusion that the update for 2005 is likely to equal the MMA minimum of 1.5 percent.

Endnotes

1 MedPAC recommended an update for 2005 of 2.6 percent (MedPAC 2004).

2 For the SGR, physician services include services commonly performed by a physician or performed in a physician's office. In addition to services paid for under the physician fee schedule, these services include diagnostic laboratory tests and drugs covered under Medicare Part B. To estimate this factor, CMS uses a weighted average of the Medicare Economic Index (MEI), a measure of changes in input prices for physician services, the change in payment rates for laboratory services legislated by the Congress, and a weighted average of the change in payment rates for Part B-covered drugs.

3 As required by the MMA, the real GDP per capita factor in the SGR is measured as a 10-year moving average.

4 For the update, physician services include only those services paid for under the physician fee schedule.

5 This adjustment maintains the budget neutrality of a technical change in the calculation of the update intended to reduce year-to-year changes in the conversion factor.

6 Without this limit, CMS estimates that the adjustment would equal –10.0 percent.

7 Historical changes in the MEI are published by the CMS Office of the Actuary (2004).

8 For 2005, CBO projects an overall increase in Medicare Part B enrollment of 1.4 percent.

9 There is a difference of $30 million between the spending increases and the spending decrease. This difference is not large enough to appear in the SGR as a change in spending due to law and regulation because it is less than 0.1 percent of spending for physician services.

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